THE ECONOMIC SITUATION

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September 2006

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- **Look what the Fed has wrought.**
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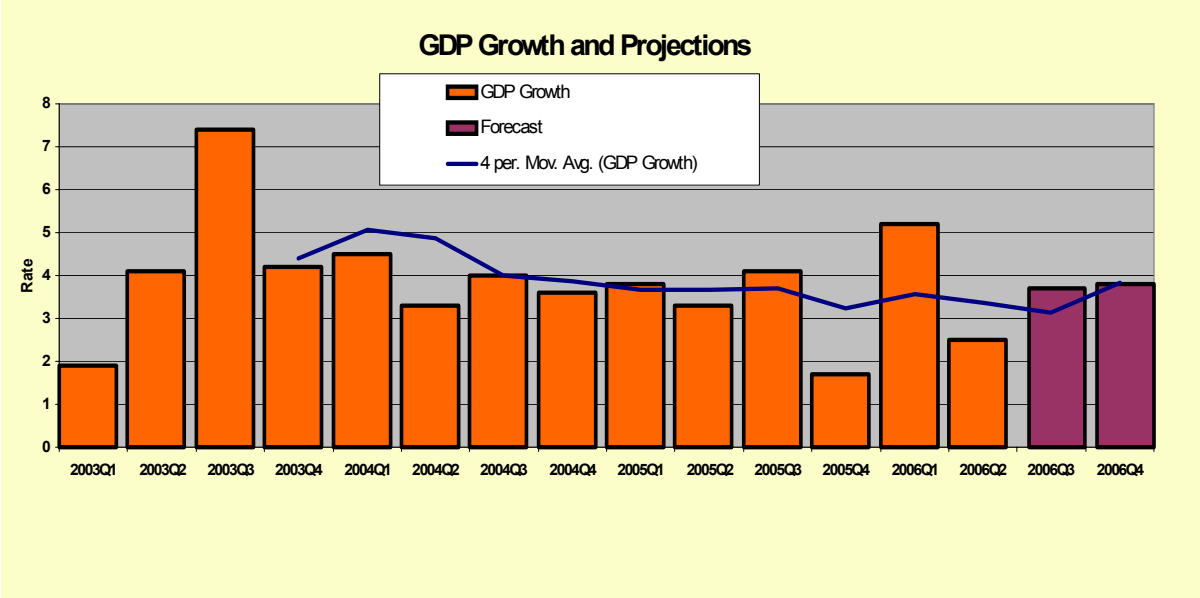
Slowing down. But is it a soft landing?

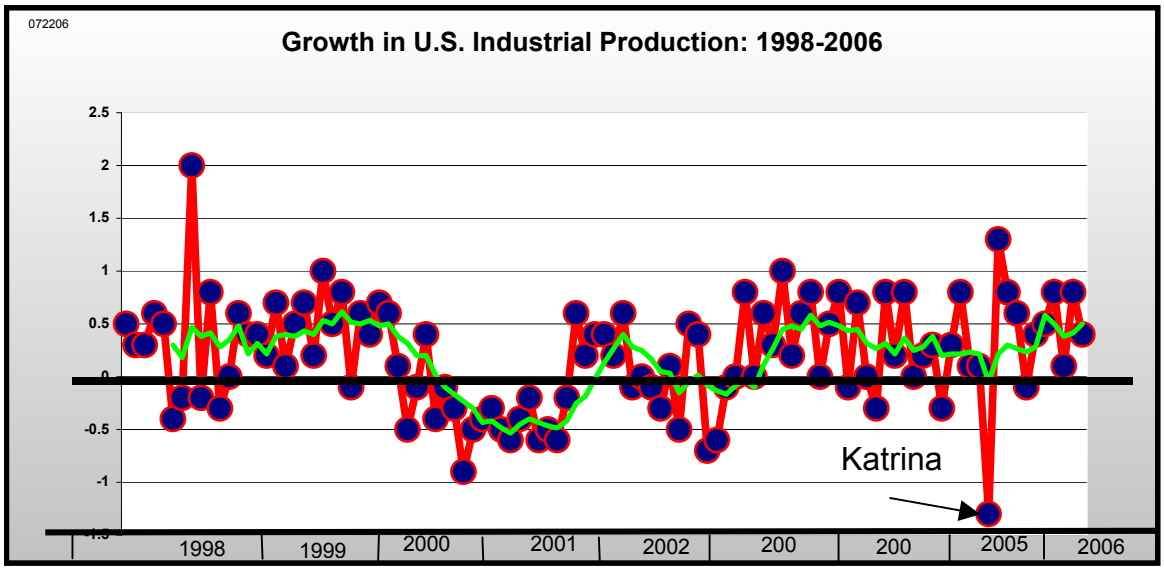
When first estimates for second quarter GDP growth arrived to the tune of 2.5% real growth, after the simmering 5.3% first quarter growth, folks naturally asked if this was the much-heralded soft landing, or was it something else? Most likely it is a combination of the Fed desired slower and, in their view, safer economy and a tough combination of war-induced uncertainty, disrupted energy supply chains, and the cumulative effects of rapid growth of deficits and federal regulation.



The chart here tells the tale. Buried in the data are the effects of 1Q2006 deep discounts in the auto sector, which captured sales that ordinarily would have come in the second quarter. So even with the slow down, the 12-month running

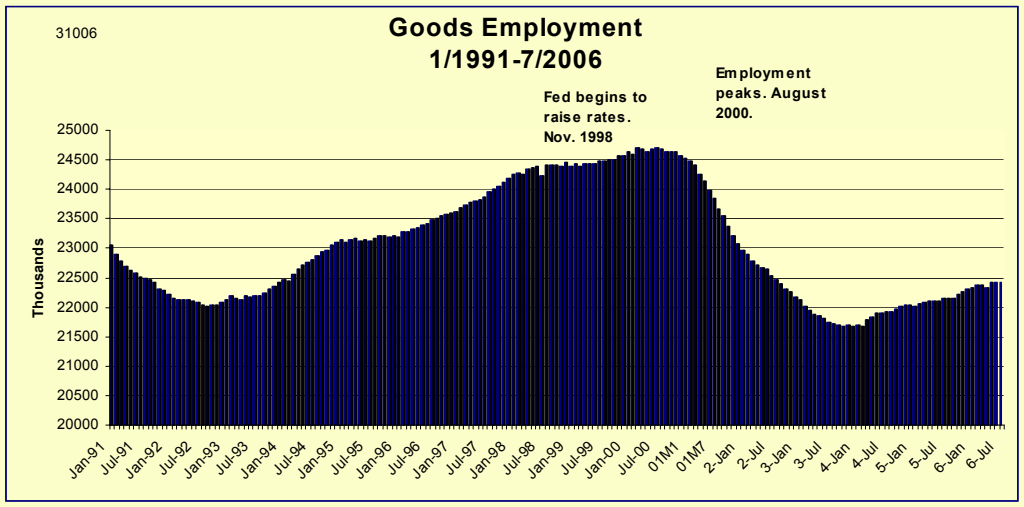
average for GDP growth is still hitting close to a somewhat throttled historic norm. We have a ho-hum economy, which is much better than having a sick one. But we should not be satisfied with such low arthritic performance.

We see a more detailed picture in the next chart, which reports monthly Industrial Production data. Here, we see a modern day miracle following the September 2005 post-Katrina collapse. The wonderful market economy recovered its beat in one month, just 30 days. Since then, as the chart reports, Industrial Production has been pecking along at a healthy pace. Yes, the manufacturing economy is alive and pumping.



But the composition of manufacturing employment has changed.

The next chart shows what has happened to employment in manufacturing. Notice the August 2000 peak. At the time, there were 23.6 million employed in the goods producing sector. Now, with some 22.4 million so employed, it would take a miracle to recover to the August 2000 levels. Indeed, over the last 30 years, the U.S. has seen five million manufacturing jobs disappear.



The trend will continue. But while total employment is falling, we are seeing a dramatic increase in high-skill manufacturing employment and therefore a rise in manufacturing wages.

Richard Deitz and James Orr reporting in the Federal Reserve Bank of New York's *Current Issues*, tracked low-, mid-, and high-skill components of employment in manufacturing. Across 1983-2002, their sample shows employment in high-skill occupations rose 37%, or roughly 1.2 million jobs. These now make up 25% of the manufacturing labor force. Low-skill jobs declined 25% from 1983, a loss of approximately 2 million jobs, and mid-skill jobs fell by some 18%. Of course, not every industry experienced equally large gains in high-skill jobs. But those industries using the most skilled labor in 1983 had the largest increase in the high-skill share.

Of course, high skill means higher pay. In 2002 the average hourly pay for low skill jobs was $11.00. High-skill workers earned $24.00 per hour.

Look what the Fed has wrought.

What's going on now? Has the Fed really affected the economy?

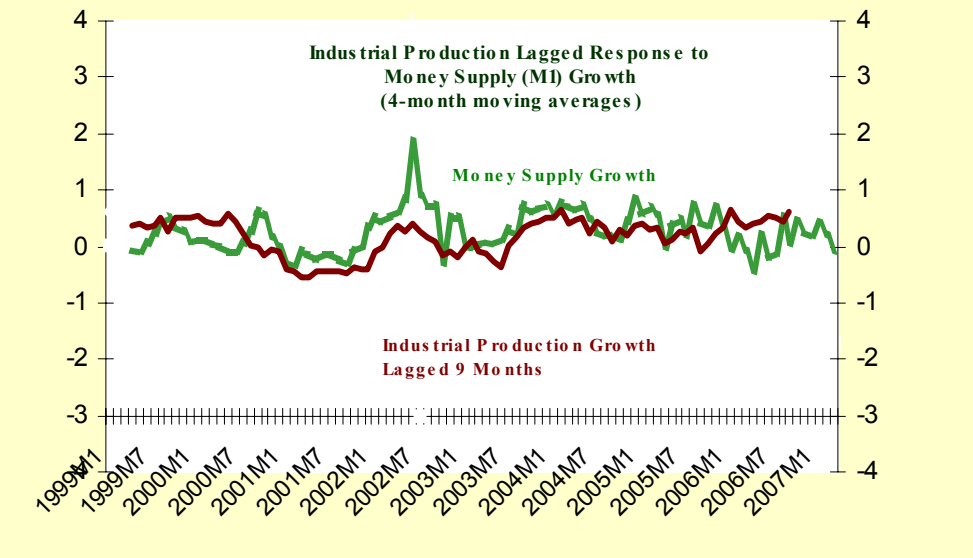
When all else fails, consider logic and theory. The equation of exchange, which may also be an identity, says the following: The volume of money circulating in an economy defines the money value of goods and services moving through the economy. The equation is written: MV=PQ, or the amount of money, M, multiplied by its movement, or velocity, V, equals the quantity of real stuff produced and exchanged, Q, multiplied by the price level, P.

Now, let's play with it a bit. In a very short period, the amount of goods, Q, cannot increase very much. So, if there is a sudden increase in M, and velocity is constant, then, P, inflation must rear its ugly head. Over a longer haul, increases in M can induce increases in Q. Of course, all this works in reverse too. Decreases in M can lead to reductions in inflation. And in a longer term, decreases in M can lead to reductions in output, especially when the decreases are unexpected.

This is a good place to interject a concern about efforts by the Fed to protect against inflation. There is a major difference between rising oil and energy prices and a rising price level. Rising energy prices cannot cause inflation. Inflation—an increase in the price level—only occurs when more money moves into the economy.

It turns out that there is a lag between money entering the economy and the economy responding. So, when the Fed takes an action to slow us down, it takes 9 to 10 months to observe the response.

I have mapped a relationship between growth in one measure of the money supply, M1, which is currency and demand deposits, and changes in industrial production. The industrial production response is lagged nine months. The data are shown in the next graph.



Near the end of the graphed series, the nine-month lag gives money growth observations awaiting industrial production data. Notice the green line and the money supply growth pattern. The money supply is growing very slowly, approaching negative rate. Forecast? Industrial production will weaken over the next nine months and may approach zero growth.

Is this a soft landing?

Since I do not know the definition, I cannot say if the Fed has delivered a soft landing. I also warn the readers. The relationship shown in the chart is not perfect.

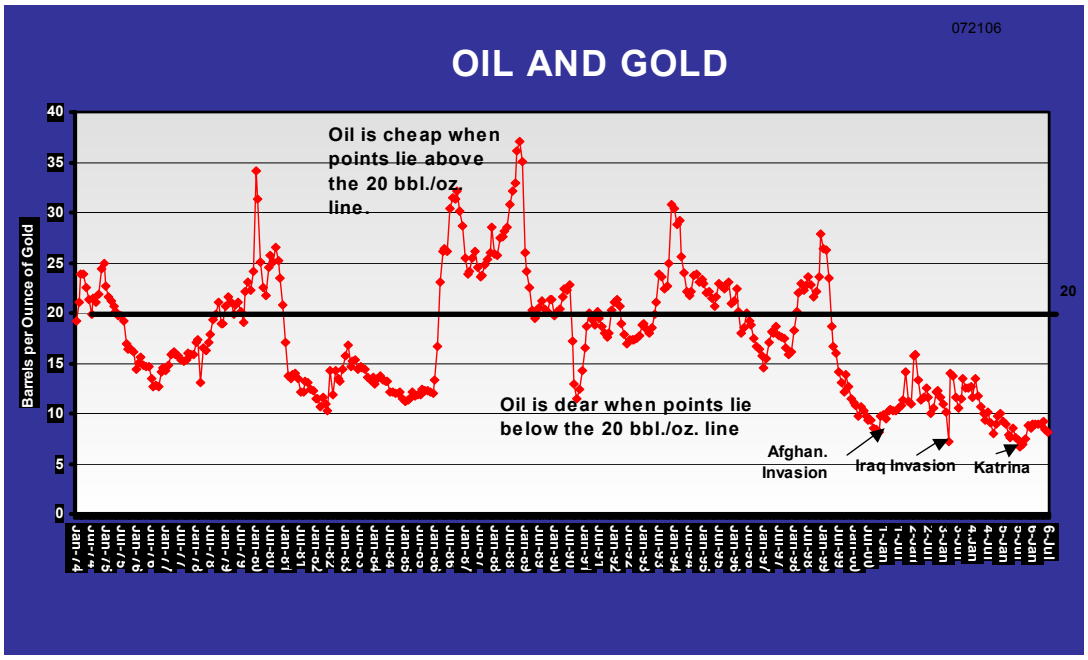
The bludgeoned petroleum economy.

Petroleum's modern history is filled with stories of cartels, political dealing, war, and setting up puppet states to assure the flow of the black gold. There is also the "resource curse" that comes with ownership of huge reserves. With so much national wealth available from oil, why work? Why learn non-petroleum skills? Indeed, why learn any skill at all? Why not sit back and let the rest of the world send gold in exchange for oil?

Once again, it is time to review this newsletter's oil for gold chart. In doing so, we see a bludgeoned petroleum economy.

Recall the trading relationship being portrayed here. The assumption: Arab oil traders and others think in terms of gold. An old relationship is buried in the data. An ounce of gold buys 20 barrels of crude oil. When the price gets too high, output increases, and so on.

And now, the chart.



I have marked post-911 events in the chart. Each successive event—Afghanistan, Iraq, and Katrina—has left an imprint. Then, there is Israel-Lebanon and Chavez.

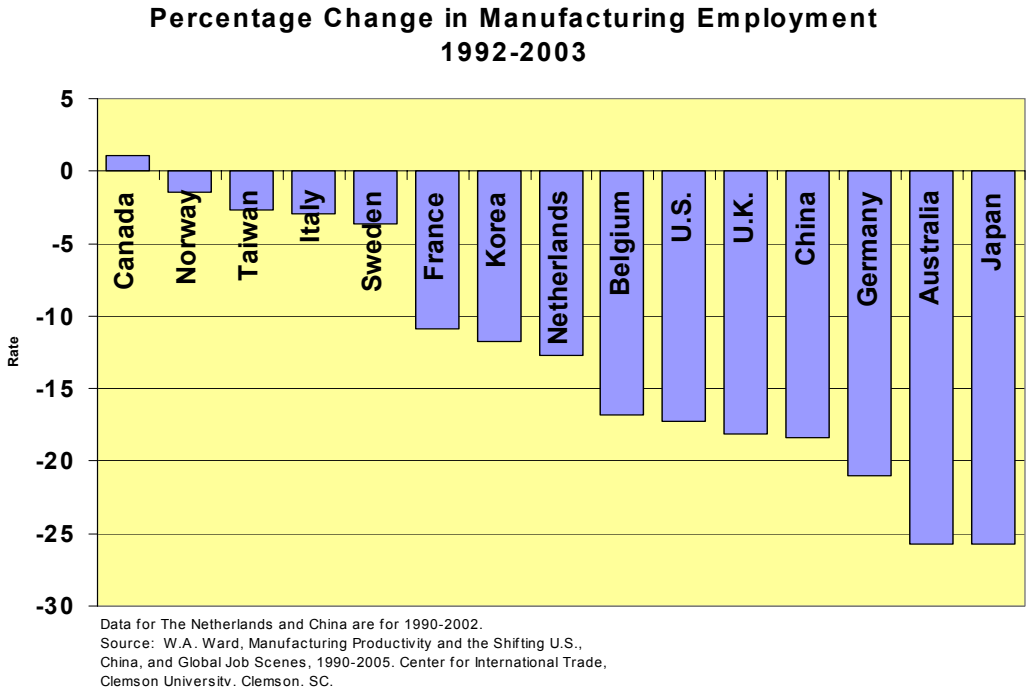
Will the Oil-Gold relationship return? A return to the market equilibrium line would mean $32 oil, which is unlikely to be seen as long as the other invasion/destruction actions are in place.

But we might see $60.

Two charts that bear repeating.

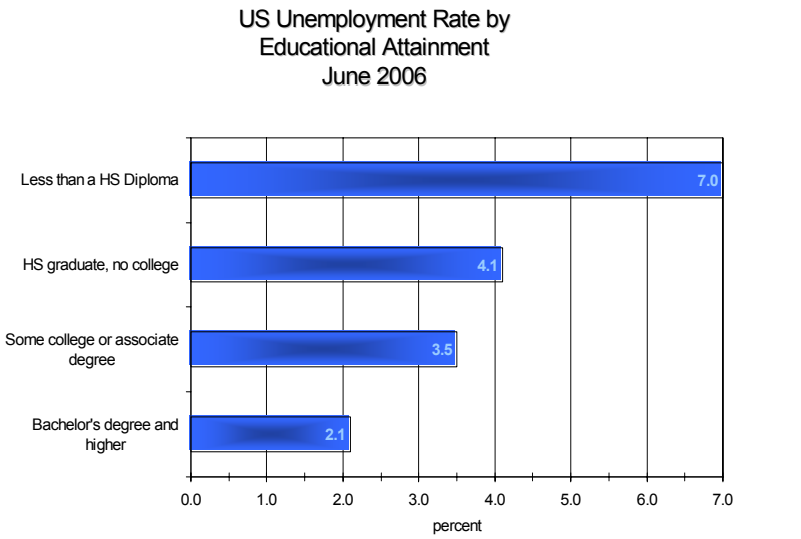
In presentations I make to audience in Washington and elsewhere, I find there is deep fascination and surprise when I show the chart that reports growth in manufacturing employment for countries representing 95% of worldwide manufacturing. The surprise always is that China shows greater losses than the U.S., and that Canada is the only country showing employment growth. Yes. All the jobs are going to Canada.

The data are from a study done by Clemson economist Bill Ward, director of the Center for International Trade. The report is on the website, www.clemson.business/cit. The chart is repeated here.



What we observe in the chart is the result of massive gains in productivity that are occurring worldwide.

A second slide that gets lots of attention from national and regional audiences shows U.S. unemployment based on educational attainment. Clearly, the unemployment problem is an education problem. The chart for June 2006 is shown here. I wish this could be placed in every U.S. classroom.

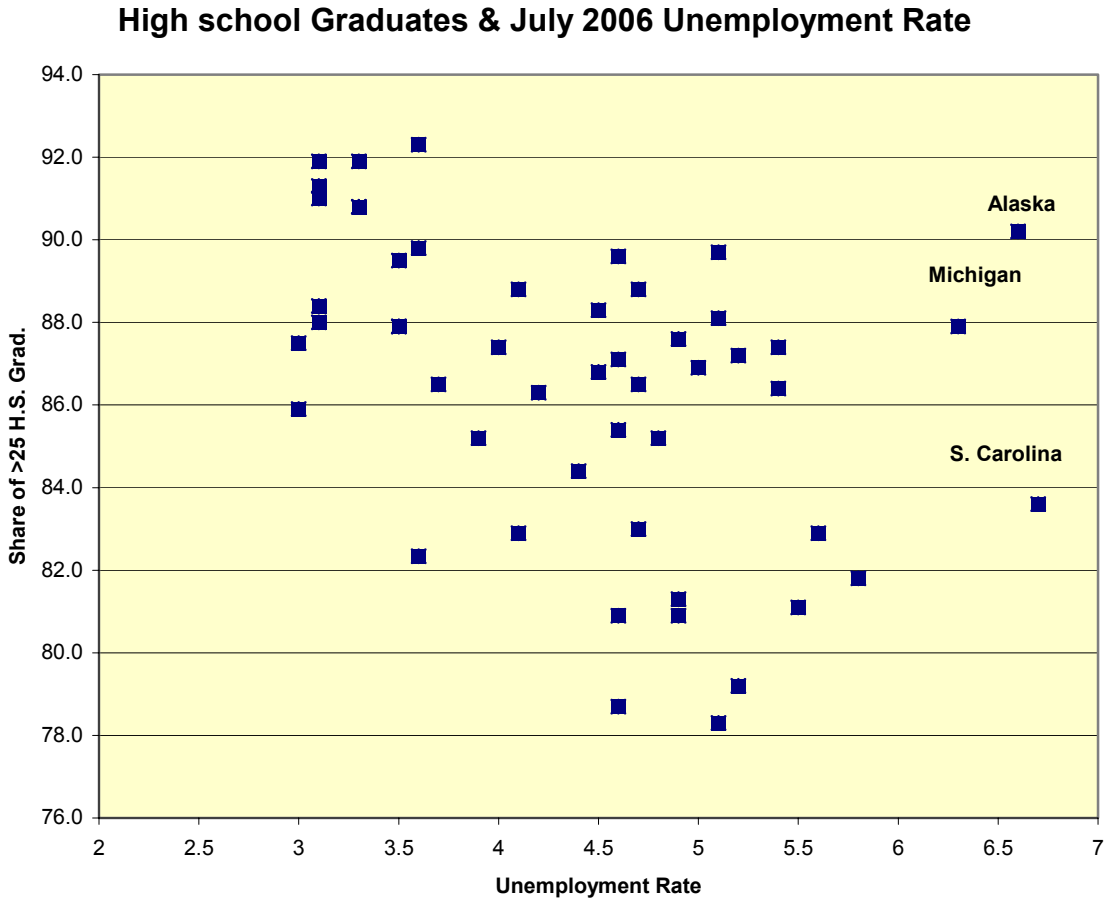


Employment status of the civilian population 25 years and older by educational attainment
Source: Bureau of Labor Statistics

Mapping educational attainment to unemployment.

In an effort to observe the relationship between educational attainment across the states and state unemployment rates, I mapped the percent of the 2004 over-25 populations with high school education or more into the July 2006 unemployment rate. Given what we know about unemployment and education, we expect to see a negative slope to the array of points, where unemployment is on the vertical axis and education attainment is on the horizontal axis.

What I found is shown in the next chart.



There is a negative drift toward the southeast corner of the chart. But notice the three outliers—Alaska, Michigan, and South Carolina. These three states clearly have structural problems. In each case, educational attainment calls for less unemployment. These are also the only three states with unemployment greater than 6.0%. Each state has underutilized human capital.

South Carolina's economy. More to the problem than unemployment.

South Carolina's persistently high unemployment rate continues to be the subject of policy debates in Columbia and elsewhere. Since state revenues are strong, some argue that the unemployment rate should improve. Having seen no improvement in three years, the critics suggest there are questions about the number itself.

It is useful to probe into the underpinnings of the monthly unemployment rate, how it is calculated, and if it could be biased for some reason. Revisions do take place from time to time, and the changes can be rather dramatic.

But there is more to South Carolina's problem economy than seen in the unemployment rate. There are other measures of economic well being that appear to be less than stellar.

For some time now, Don Hilber in the Office of Career and Technology Education of the S.C. Department of Education has tracked 16 indicators of economic performance for the U.S., S.C., N.C., Georgia, Tennessee, and Alabama. The metrics include growth in state revenues, growth in per capita income, personal income, gross state product, different indicators of employment growth, and several indicators for housing.

Don was kind enough to share his August 2006 scorecard with me.

South Carolina and Tennessee rank at the bottom of the scorecard. Of 16 measures, South Carolina and Tennessee exceed the national average for six of them. North Carolina does slightly better, outperforming the nation for seven indicators. Alabama is the stronger state, excelling on 11 of 16 indicators.

Where is South Carolina hurting most? The state is also relatively weak in personal income growth (28th) and, as might be expected, growth in total state product (36th). While state revenues are stronger than in the recent past, things are not all that great compared with other states. The Palmetto state ranks 39th among all states in FY06 revenue growth.

But while there are measured weaknesses, there is also interesting news on S.C. strengths. A March 2006 report on labor productivity growth by state published by the Federal Reserve Bank of Cleveland shows data for 1977-2000 and 2000-2004. For the longer period, which ends just before the onset of the last recession, South Carolina ranks number 12 in the nation. For the most recent period, South Carolina is fifth from the top. Interestingly enough, South Carolina ranked third in the nation in the gain is the college-educated share of the adult population.

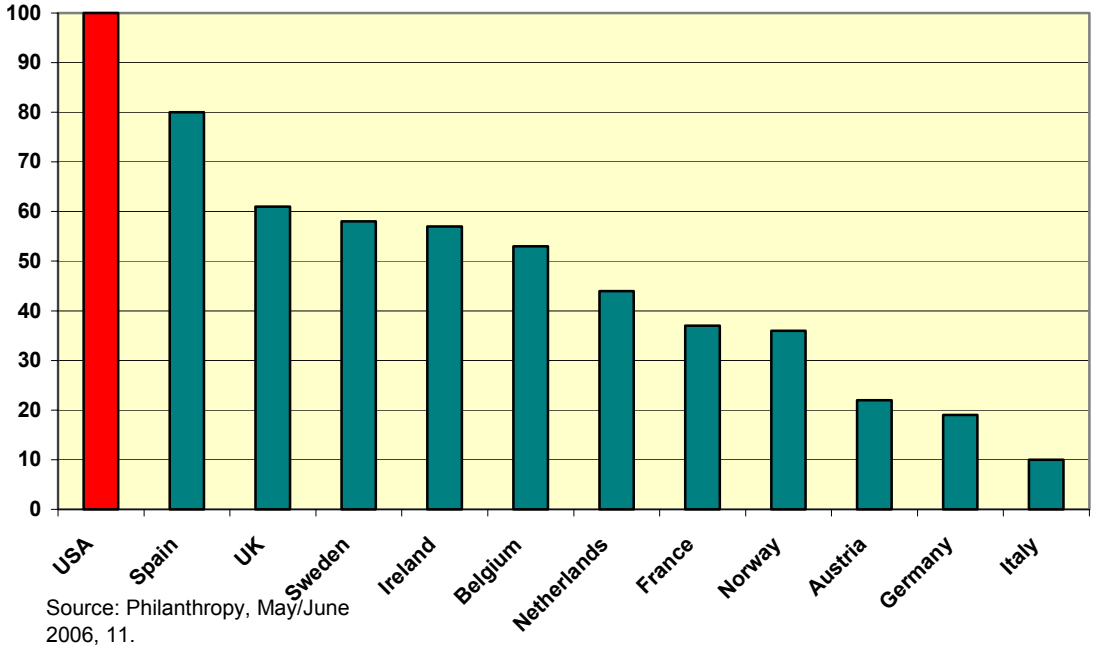
The linkage between education, productivity, and personal income tell us that improvements in S.C. personal income are on the way.

Those generous Americans.

The latest issue of *Philanthropy Magazine* reports on research by Hudson Institute scholar Carol Adelman that compares cross-country charitable behavior. Not stopping with politically determined aid to victims of national and international disasters, Adelman includes gifts from private individuals, foundations, universities, and religious congregations. According to the U.S. Agency for International Development data, government aid from the U.S. is approximately 0.1 percent of GDP. When private gifts are added, the GDP share jumps to 0.5 percent of GDP. By the way, Americans privately gave $1.5 billion in tsunami relief and $3.4 billion to assist Katrina victims.

A cross-country comparison of share of 1992-2002 national income contributed to charity is shown in the accompanying graph.

Charitable Gifts, U.S. Comparison
1995-2002



Source: Philanthropy, May/June 2006, 11.
Comparative Nonprofit Sector Project, Johns Hopkins

Julius Rosenwald, another hero.

Julius Rosenwald, featured in the June 2006 issue of *Philanthropy,* started his stellar business career with Richard W. Sears, the founder of Sears, Roebuck. Rosenwald ended his career as one of America's richest and most generous philanthropists.

As is often said, it is much harder to build wealth in a competitive economy than to give it away. But his philanthropy was a bit different, to say the least. He built schoolhouses for African American children.

But let's go back a bit. In the late 1800s, Richard W. Sears took on Aaron Montgomery Ward in a quest to become the dominant mail order supplier to America's farmers. Sears began by selling watches and jewelry. Understandably, his first partner was, Alvah Curtis Roebuck, a watchmaker. But Roebuck left in 1895, and Sears joined with Julius Rosenwald to form a "power couple" that propelled the Sears company far beyond Montgomery Ward.

Julius Rosenwald was apparently a consummate 'Mr. Inside." He brought efficient supply chain management to the growing enterprise, finding ways to reduce cost, improve quality, and provide low-cost convenient access to a huge population of farmers. Sears, the advertising genius, took care of the outside. "Satisfaction guaranteed or money back" was the signature slogan. By the turn of the century, Sears and Rosenwald were counted among America's wealthiest individuals.

Rosenwald and Sears became wealthy by finding new ways to make people happy. They did well by doing good. They pass the first hero test.

Perhaps knowing that he had already made this world a better place, Rosenwald became attracted to yet another challenge. Somehow the book *Up from Slavery* by Booker T. Washington came into his hands. Rosenwald became interested in Washington, and this led to his interest in the plight of rural African-American children. Good schools in those communities simply did not exist. Rosenwald established a new approach for building schools for Blacks in the rural south. He would fund one-fourth the cost, with a requirement that the Black community provide one-fourth—in cash or in sweat--and state government provide the balance.

The Rosenwald school project began in 1914. When he died in 1932, the Rosenwald fund, by spending $4.4 million, had helped build more than 5,000 school buildings for rural African-American communities. South Carolina received 500 of these. Following the Rosenwald formula, Black S.C. families contributed a half million dollars to build these schools. Whites gave a quarter million dollars. Some $1.7 million in taxpayer funds was allocated to the buildings, and Rosenwald gave $435 thousand.

Rosenwald's creativity did not end with the idea of partnering to yield a sense of ownership in the program. He also provided Rosenwald radios to the schools so that the children would have available the latest technology for learning. And to make certain that his funds were spent properly and to avoid the common problem of mission drift that tends to occur in foundations when the founder is no longer on the scene, Rosenwald specified that all the funds be spent in 25 years and the foundation closed.

Rosenwald was a double hitter. By dint of hard work and creativity, he built a fortune by finding ways to provide lower cost goods to ordinary Americas. After performing that amazing feat, he used some of his wealth as matching funds for building thousands of schools for African Americans in the rural South.

He did well by doing good, and did good again. A real American hero.